CREDIT SCORE SOCIALISM PUNISHES GOOD BEHAVIOR

The Federal Housing Finance Agency (FHFA), the regulatory agency that oversees government-sponsored enterprises (GSE), has allowed Fannie Mae and Freddie Mac to change their mortgage fee structures in ways that punish good financial behavior. Individuals with higher credit ratings generally receive a lower mortgage rate than those with lower credit. However, the changes made by the GSEs will raise rates on borrowers with good credit, even those with high down payments, to subsidize lower-credit and higher-risk borrowers.[1]

This method of wealth redistribution is a way to socialize the risk of home loans. David Stevens, the Commissioner of the Federal Housing Administration (FHA) under President Obama, estimated that this mortgage rate restructuring could cost high-credit borrowers an additional $40 a month on a $400,000 loan.[2] This disincentivizes home ownership for reliable borrowers and incentivizes it for those without a history of paying back their debts.

Both situations could have catastrophic implications for our economy. A policy of punishing those who have made more sound financial decisions is a fundamentally un-American way of picking winners and losers in homeownership.

BACKGROUND

- **Why Credit Scores Are Important**

  Credit scores are the borrowing equalizer in our economy, and their equality stretches across many different economic backgrounds. The Fair Isaac Corporation, better known as FICO, which is the premier credit scoring service, calculates scores in the following way:[3]

  - Payment History (35%)
  - Amount Owed (30%)
  - Length of Credit History (15%)
  - Credit Inquiries (10%)
  - Credit Mix (10%)

  With these metrics, lenders can determine the risk of lending to individuals and charge them an interest rate based on that risk. Prime rates are what banks charge their most creditworthy customers and are lower than what is offered to borrowers with subprime credit scores. A "subprime" credit score varies by institution. Experian, one of the "Big Three" credit reporting agencies, lists it as anything below a FICO score of 670.[4]

  Data illustrates the effectiveness of using an individual's credit score in predicting the likelihood of default. In a study conducted by the American Enterprise Institute and the Federal Housing Finance Agency (FHFA),[5] individuals with a FICO score of over 770, a debt-to-income (DTI) ratio of 33% or less, and a cumulative loan-to-value rate (CLTV) of under 60% or less, have merely a 0.5% chance of defaulting on their mortgage. Those within the same DTI and CLTV but have under a 580 FICO score have a 21.3% chance of defaulting.

Even those in the 660-689 credit bracket have a 3.4% chance of default, which is 6.8 times higher than those in the top FICO bracket.

However, those within the report's highest FICO bracket (over 770) and the highest DTI bracket (over 50%) still have a 0.8% default rate. This data point justifies lenders offering mortgages to lower-income Americans who have faithfully paid off previous lines of credit.

In its 2007 report to Congress,[6] the Board of Governors of the Federal Reserve stated that "the greater accuracy offered by credit scoring can help ameliorate the problem of 'adverse selection' that arises when lenders offer a single interest rate to potential borrowers with varying credit risks." They also stated that "[i]f credit scoring permits the introduction of a more accurate risk-based pricing system, so more borrowers will be charged prices that more closely reflect the credit risks they pose, the result is a system that is more fair and efficient."

- **The Catastrophic Impacts of Subsidizing Home Mortgages**

  This backward policy incentivizes improper financial behavior in Americans. It further punishes middle- and lower-class Americans who have been responsible with their resources and seek to better the lives of their families through a home purchase. Taxpayers already subsidize homeownership opportunities for low-income borrowers through the FHA, and sticking many of these same Americans with the bill to subsidize high-risk loans is doubly unfair.[7]

  Americans haven't forgotten the crisis created by pushing people into homes they could not afford in the early 2000s.[8] Like it did then, subsidizing homeownership for individuals with poor credit histories by encouraging greater levels of debt creates enormous moral hazard risks, establishing perverse incentives for both borrowers and lenders to originate higher levels of debt, all of which have resulted in enormous costs to taxpayers during periods of economic distress.

POLICY SOLUTIONS

- Congress must ensure that the FHFA adheres to current law, including statutory requirements prohibiting the FHFA Director (a political appointee nominated by the President) from allowing any changes in allowable guarantee structures by GSEs that would lower underwriting standards and increase risk in their portfolios.[9]
- Congress should pass legislation like the Protecting American Taxpayers and Homeowners Act of 2018,[10] which would reduce the scope of power the federal government holds in the mortgage finance system, including ending the federal conservatorship of Fannie Mae and Freddie Mac, the two GSEs that Congress bailed out in the housing crisis of the late 2000s.
- Congress could also reduce the scope of intervention these two GSEs hold in the nation's housing market by reforming the allowable loan limits and the guaranteed fees that the GSEs charge lenders to cover credit risk on securities.
- Congress should also pass the Responsible Borrower Protection Act of 2023, which would undo this action by FHFA and the GSEs.[11]

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